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Supreme Court of the United States

OCTOBER TERM, 1936.

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EDWARD SCHAFER, Petitioner, vs. GUY T. HELVERING, Commissioner of Internal Revenue, Respondent.	No. 25.
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REPLY BRIEF FOR PETITIONERS.

I.

The provisions of the statute confirm the construction of the regulations for which we contend.

Since the Commissioner has prescribed uniform regulations under Section 22 (c) of the statute, under the authority

judicially approved in *Lucas* v. *Structural Steel* Co. (1929), 281 U. S. 264, at p. 268, the application of those regulations to a given state of facts becomes a judicial question.

See:

Russell v. *Commissioner* (C. C. A., 1st Cir., 1930), 45 Fed. (2d) 100, at p. 101;

Seeley v. *Helvering* (C. C. A., 2nd Cir., 1935), 77 Fed. (2d) 323.

The fountainhead of the Respondent's regulations respecting inventories remains the statute itself, the language of which is paramount in arriving at a proper construction of Article 105.

Whether or not the statute compels the Commissioner to allow for use of inventories in a proper case, once he has proceeded to prescribe his regulations they must conform "as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

We accordingly urge that any regulation, once adopted by the Respondent, must be construed in the light of the statute's expressed provisions.

In attacking the problem herein presented, Respondent is therefore faced at the outset with the requirement of the New York Stock Exchange and the uniform practice adopted for years by Schafer Brothers, together with the undisputed evidence that the partnership, in the course of its business, could only determine its periodical income and financial condition from the market values of the securities owned by it from time to time.

Petitioners do not contend that the inventory section is a "relief" provision. All they ask is that the law and regulations be applied to them in such manner as most clearly to reflect the income of the firm's business.

See *Commissioner* v. *Stevens* (C. C. A., 2nd Cir., 1935), 78 Fed. (2d) 713, where the Court said at page 714:

> "Congress did not vest the Commissioner with powers by administrative requirement to deprive

dealers of the right to use inventories which are necessary to clearly determine its income where, as here, the actual method employed conformed, as nearly as possible, to the best accounting practice in the trade and most clearly reflected income, and where there has been a substantial compliance with the statute and regulations. United States v. United Verde Copper Co., 196 U. S. 207, 25 S. Ct. 222, 49 L. Ed. 449; In re Clicquot Club Co. v. United States (D. C.), 13 F. (2d) 655."

II.

The firm has complied with all the approved requirements of Article 105 to warrant its classification as a dealer.

There is No Question of Insufficient Findings.

The findings of the Board (R. 33) establish in so many words that the partnership bought and sold securities for its own account "as a part of its business activities." This should dispense with any possible inference Respondent may have endeavored to convey that the transactions in the "Error Account" were sporadic or in the nature of a "sideline."

The Board has also found (R. 33) that the partnership was "a dealer and merchant in securities on commission and on margin."

In executing orders on commission, the firm was an agent and could not be a dealer. So, in carrying accounts on margin for its customers, the firm was a pledgee and not a dealer.

Much of Respondent's argument arises from the confused use, often in respectable quarters, of the term "dealer." A dealer is always of necessity a principal.

Since the Board has found that the firm was a dealer in securities, its activities in that capacity are necessarily exclusive of its operations as Stock Exchange brokers. The application of that term to its activities is consequently limited to its operations as a principal, and those operations comprised, besides its participation in syndicate and under-

writing operations, the purchase and sale of securities for profit "as a part of its business activities."

Respondent is therefore in no position to assert that the findings are insufficient to justify the firm's classification as a dealer if the facts establish that status as a matter of law.

There is No Warrant in the Statute or Regulations For Respondent's Contention That a Dealer Must Hold Himself Out to the Public That He Has Securities For Sale.

Respondent predicates his entire argument against the firm's compliance with the prerequisites classified as Nos. 4, 6 and 7 of our memorandum-in-chief, upon the absence of elements establishing a so-called "holding out."

Nothing in the language of those requirements in Article 195 envisages a factual representation that the "dealer" has securities for sale, aside from the daily activities of any trader in securities who offers his wares for sale to anyone at a price.

Respondent's effort to predicate his position upon the use of the word "merchant" is sufficiently answered by the repeated judicial definitions of that term, set forth at some length in our memorandum-in-chief, by which *a merchant has been held to be any non-processing dealer or trader provided he has an established place of business from which his sales are conducted.*

We submit that this is precisely why the last sentence of Article 105 lays stress upon the existence of an established business, and a place from which that business is conducted.

Many a dealer in merchandise sells through agents and may never know the identity of the ultimate purchaser, but remains a merchant notwithstanding.

To draw a closer analogy, it is common knowledge that the underwriter or wholesaler of a bond or stock issue will deal in large part through brokers and houses of issue, to whom is allowed a commission for the services rendered in distributing the securities among the latter's clientele.

That very underwriter may have no more knowledge of the ultimate purchaser than had Schafer Brothers respecting the identity of those who purchased the securities they offered for sale, but we are confident that Respondent will not deny the application of Article 105 to such an underwriter.

We accordingly submit that the views of the Second Circuit in the *Stevens* case correctly interpreted the requirement of "sales to customers" to embrace any party who was willing to buy from the taxpayer firm.

The Firm's Trading Activities Were Conducted as a Part of Its General Business Activities.

Our analysis of the findings (this brief, p. 3) establishes that the firm's trading activities were a part of its business and not a side line. Since elements of speculation enter into the activity of every dealer, or one who depends for his profits (whether in merchandise or securities) on the fluctuations of the market (see our memorandum-in-chief, pp. 15, 16), the vital element of Prerequisite 9, arising under the last sentence of Article 105, is the factor of an established business, and place of business, to enable such dealer or trader to fall within the definition of a "merchant."

We coincide in Respondent's view that the sentence was ineptly phrased to maintain his contentions on this appeal, and invite attention to the change in phraseology appearing in his regulations adopted under the *subsequent* Revenue Acts of 1932 and 1934, analyzed herein at a later juncture.

Our Contentions Respecting the "Wash Sale" Provision Are Made in the Light of Respondent's Own Interpretation, as Approved by the Board of Tax Appeals.

We contend that any party who is exempt from the "wash sale" provision under Section 118 of the Law is so exempt because that same party would have the correlative right to inventory his securities. We contend that the words "one

in the trade or business of buying and selling securities," described in the Regulation interpreting Section 118, is necessarily a dealer in securities under Article 105 and entitled to inventory the same under Section 22(c).

One of the very authorities relied upon by Respondent, being *Donander Co.*, 29 B. T. A. 312, involved the right of a corporation that had been organized to take over the assets of a decedent's estate, to avail itself of the exception to Section 118 of the Revenue Act of 1928.

The Board, in holding that the exception to the "wash sale" provision was not properly invoked by the Donander Co., applied in its determination the rulings made *under the inventory provision of the Statute,* and determined in so many words that a "dealer in securities" under the inventory provisions occupied precisely the same status as "one in the trade or business of buying and selling securities" under Article 661 of Regulations 74, which interprets the exception to Section 118. (See 29 B. T. A., at page 314, from which it appears that the Commissioner, Respondent in that case, had taken precisely that position.)

In the later case of *Walter Thiele,* 32 B. T. A. 134, the Board held that an *individual trader on margin* might properly indulge in "wash sales" under Section 118, even for the admitted purpose of realizing income tax losses in 1929.

Respondent's strictures respecting the naivete of our contentions is sufficiently answered by his own position in the *Donander* case, as well as by the general application of the "wash sale" provisions, which would penalize the class of persons entitled to avail themselves of the inventory provisions who might sell and repurchase those securities within thirty days, unless an exception were enacted in their favor as has been accomplished in Section 118 of the 1928 Act.

The Effect of the Stock Exchange Regulation.

We do not contend that the Stock Exchange rule requiring its member firms to inventory their securities of itself binds the Federal tax authorities. The regulation and Schafer Brothers' compliance therewith is, however, persuasive evi-

dence that so much of the petitioners' income as was based upon the taxable income of the firm requires the use of inventories so as to conform as nearly as may be to the best accounting practice in their particular trade or business and as most clearly reflecting the firm's income, in the language of Section 22(c). Article 105 must, of course, be construed in such a manner as best to carry out the spirit of the statute.

Nor does this suit involve merely respective merits of accounting, since the right of any taxpayer to be classified in a particular manner for the purpose either of the statute or of the regulations remains at all times a judicial and not an administrative question.

The Decisions in the Stevens and Charavay Cases Were Not Predicated upon the Claim That Those Taxpayers Were Specialists.

Both of the taxpayers involved in the foregoing cases were members of the firm of Stevens & Legg. That firm was a specialist only in the securities of the New York Dock Company, but the courts nevertheless sustained the action of the Board granting the right to inventory securities of numerous other companies held by the partnership (see 29 B. T. A. 1260).

In the recent case of *Vaughan* v. *Commissioner*, the Second Circuit reaffirmed that the right to inventory approved in the *Stevens* case was not limited to the stocks in which that firm acted as specialists. (See I Prentice Hall, 1936, Federal Tax Service, ¶1509, at p. 1677).

The remaining authorities relied upon by Respondent appearing at page 11 of his brief either involved the attempt to inventory securities acquired *for investment* (*Adirondack Securities Corp.*), or the case of a surety company which was not engaged in the purchase and sale of securities as part of its general business (*Northeastern Surety Co.*), or where the taxpayer did not inventory its securities on its books and endeavored to do so thereafter when a more favorable tax situation seemed to invoke that practice (*Northeastern Surety Co., Oil Shares, Inc.*). The *Donander* case

has previously been discussed and, as stated, involved an estate holding company, which would scarcely appear to embrace the purchase and sale of securities as a business within its purview.

III.

The consistent practice and rulings of the Bureau and the language of its regulations under all Revenue Acts from that of 1918 through that of 1928 vest the interpretation of the regulations for which we contend with the force of law.

We do not maintain that the doctrine of estoppel may be asserted against a sovereign to preclude the exercise of a power inherent in its sovereignty. We do maintain that the facts of this case and the history of Article 105 of Regulations 74 and Regulations under predecessor Acts, as applied to Section 22(c) of the Revenue Act of 1928 (and the corresponding sections of predecessor Acts), impel the conclusion that the construction of the Regulation for which we contend has the force of law.

This Court said in *Fawcus Machine Co.* v. *United States* (1931), 282 U. S. 375, at page 378:

> "* * * The regulations were made pursuant to express authority (see §1309 of the Revenue Act of 1918). They are valid unless unreasonable or inconsistent with the statute. *United States* v. *Grimaud*, 220 U. S. 506, 517-518; *International Ry. Co.* v. *Davidson*, 257 U. S. 506, 514. They constitute contemporaneous construction by those charged with the administration of the act, are for that reason entitled to respectful consideration, and will not be overruled except for weighty reasons. *United States* v. *Moore*, 95 U. S. 760, 763; *Brewster* v. *Gage*, 280 U. S. 327, 336."

Due to Respondent's interpretation of Article 105, at variance with its language and particularly of its last sentence,

we have since been impelled to examine the Regulations promulgated by Respondent under the provisions of the two succeeding Revenue Acts, and take the liberty of inviting to the Court's attention that although Article 105 has been modified in Regulations 77, promulgated under the Revenue Act of 1932* (and also Article 22[c]-5 of Regulations 86, promulgated under the Revenue Act of 1934), *Respondent has at no time seen fit to amend Article 105 of Regulations 74 or any corresponding predecessor Regulations.*

Since the Revenue Act of 1928 is an enactment separate and distinct from the succeeding Revenue Act of 1932, the determination of Respondent respecting the use of inventories must be derived from within the four corners of the Regulations promulgated by him under the earlier Act. The only Regulation he has so prescribed is Article 105 of Regulations 74 which were promulgated by the Respondent with the approval of the Secretary of the Treasury and have the force of law. (See *Helvering* v. *New York Trust Co.*, 292 U. S., at p. 468.) This case is governed by the Act of 1928 and not by any prior or subsequent revenue law.

Even if Regulations 77 be construed retroactively, they can have application only to cases arising under the 1932 Act. (See *Manhattan etc. Co.* v. *Commissioner* [2nd Cir., 1935], 76 Fed. [2nd] 892, at p. 897; *Bamberger*, 27 B. T. A. 785, at p. 794.)

The modification by Respondent of the last sentence contained in Article 105 confirms our view that the predicate of an established business is a primary factor in the determination of who is a dealer in securities *under the Revenue Act of 1928.* It further confirms our view that Article 105 *of Regulations 74* reads as it was intended to read, and that a Stock Exchange house buying and selling securities in the course of an established business, even though the

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* The last paragraph of Article 105 has been changed to read:

"Taxpayers who buy and sell or hold securities for investment or speculation, *irrespective of whether such buying or selling constitutes the carrying on of a trade or business*, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule,"

the italicized words having been substituted for "and not in the course of an established business," as they appear in Article 105 of Regulations 74.

transactions involve elements of speculation, are dealers in securities within its language and intent.

Else, why make mention of the words "not in an established business," or lay stress upon the profits of officers of corporations and members of partnerships in their individual capacities?

And if the factor of an established business is not a determining element, why should respondent see fit, under a subsequent law, to lay stress upon the immateriality of that factor, in direct contradiction to the language of his Regulations under the Act by which this case is governed?

Respondent will doubtless rely upon *Helvering* v. *New York Trust Co.*, 292 U. S. 455, at page 468, which supports the thesis that mere *addition* of language does not necessarily indicate intention to change the law. The views of the Court in that case are, if anything, favorable to the contentions of the petitioners, in the light of this Court's holding in *Brewster* v. *Gage* (1930), 280 U. S. 327, at page 337, that a *change* in the language of a subsequent act (as distinguished from the addition of certain words) indicates that a change of law was intended and that such change will not apply retrospectively.

There has been no change in the language of Section 22(c) since the 1918 Act was passed. A very material change has, however, been made in the Respondent's Regulations promulgated since the passage of the Act of 1932.

His G. C. M. 9656 (our brief, p. 28), issued during the latter part of 1931, which was the first inkling that he would recede from A. R. R. 755, was no more a formal promulgation by the Commissioner with the approval of the Secretary than was his earlier inconsistent ruling.

Nothing in Section 22(c), as it read under any of the Revenue Laws, precludes periodical changes in the Commissioner's Regulations respecting inventories. The difficulty with Respondent's position is that no such change was ever made under the 1928 Act or under any preceding Act (except the elimination of a comma in the last sentence of Article 105, which favors the petitioners' interpretation).

It follows that a change in language of a regulation promulgated under a separate and subsequent law inevitably creates the inference that the language of Article 105, as it read under the 1928 Act, means what it says.

No extended argument is needed to establish the gross injustice resulting from the *volte face* of the Respondent as confirmed by the opinions below. Petitioners are, however, favored by the views frequently expressed by this Court that a doctrine of taxation at variance with pre-existing practice will not be retroactively construed.

See:

Nichols v. *Coolidge* (1927), 274 U. S. 531;
Brewster v. *Gage, supra.*

The evidence and findings that establish petitioners' reliance upon Respondent's uniform course of practice to their detriment are not in dispute. It necessarily follows that the Court must give retroactive effect to a material change in the effect of the statute, which is severely prejudicial to petitioners, if the views of the court below are to be sustained.

We accordingly rest confident that, notwithstanding the sometimes arbitrary results implicit in the taxing power, the facts of this case and the gross injustice involved, coupled with the uniform history of the statute and regulations, as they persevered until long after the event and the filing by petitioners of their tax returns, afford the force of positive law to Article 105 of Regulations 74 as promulgated under the 1928 Act, and to Respondent's consistent course of interpretation thereof.

IV.

Petitioners' contention denying retroactive effect to the Department's ruling made in 1931 is properly before the Court.

In reply to Respondent's contentions that the issue of retroactive effect was not presented in the petition for cer-

tiorari, we respectfully invite attention to the following quotations appearing:

(a) In the petition, at page 4:

> "From 1925 to 1929, inclusive, in accordance with a ruling published by the Treasury Department in 1922 that stood unquestioned for some nine years, and as it was required by the rules of the New York Stock Exchange, the firm inventoried the securities purchased and held by it for resale at a profit, at market values at the beginning and end of the year, and determined its income from this source upon the inventory basis.
>
> This method of computing the firm's income was accepted by the Commissioner for all years up to 1929. For that year, in auditing the firm's returns in 1931, he denied the partnership the right to use the inventory basis in computing its income on the ground that the firm was not a 'dealer in securities' with respect to the securities which it purchased and sold for its own account that had remained unsold at the beginning and end of the taxable year.
>
> This action resulted in increasing the firm's income for 1929 (in prior years such action would have decreased the firm's income) and consequently increased substantially the taxable income of each of the partners."

(b) In the specification of errors contained in the petition, at page 5:

> "2. In failing to hold that the use of inventories in 1929 by the firm of Schafer Brothers with respect to the securities it bought and sold for profit on its own account was essential in order clearly to determine the income of the firm, and consequently the income of each of these petitioners, in accordance with the best accounting practice, *with the requirements of the Bureau of Internal Revenue* and with the rules of the Stock Exchange." (Italics ours.)

(c) In the brief in support of the petition, at page 9:

> "Here, Schafer Brothers for a number of years had computed its income from purchase and sales of securities for its own account on the inventory basis.

> The sudden rejection of that basis in 1931 by the Commissioner for the taxable year 1929 and the use by him of the actual sales basis in computing the firm's income for that year resulted in an increase on paper in the firm's income of $511,667 over the amount disclosed by its tax return."

(d) In the brief in support of the petition, at page 12:

> "The sudden reversal of opinion by the Commissioner, in diametrical opposition to his practice of over nine years, was not impelled by any change in the Statutes or Regulations, since the above-quoted provision of the Revenue Act of 1928 and the appurtenant Regulation have stood substantially unchanged since the enactment of the Revenue Act of 1918."

Further attention is invited to the lengthy discussion afforded to the precise point by Judge Groner in the last two paragraphs of the opinion of the Court of Appeals for the District of Columbia (R. 89 [87] and 90 [88]).

In his discussion, the learned Justice lays stress upon the injustice involved and the resultant increase in petitioners' taxes for previous years from observing the consistent rulings of Respondent, as well as upon the petitioners' failure to avail themselves of the exception to the "wash sale" provision contained in Section 118 of the Revenue Act of 1928, equally by reason of such reliance.

We further submit that the intimations contained in the authorities cited by Respondent in the first paragraph of his Point III (his Brief, p. 20) involve discretionary limitations; that they do not affect the jurisdiction of this Court; and that the views expressed by Mr. Justice Harlan in *Donovan* v. *Pennsylvania Co.* (1905), 199 U. S. 279, where he said at page 292:

> "As this case is before us on writ of certiorari, we can dispose of all questions arising on the record,"

is a correct exposition of the jurisdictional factor.

Assuredly, nothing contained in Section 240 of the Judicial Code, as amended (U. S. C. A., Sec. 347), imposes any such

limitation as is contended for by the Respondent since that provision empowers this Court to require by certiorari

> "that the *cause* be certified to the Supreme Court for determination by it, with the same power and authority and with like effect as if the case had been brought there by unrestricted error or appeal."

We find no such limitations in the orders allowing certiorari in the several appeals herein (R. 93).

The extent of consideration afforded to the point in the opinion of the Court below should therefor impel this Court to resolve the issue of retroactivity in connection with the remaining related questions appearing from the record and petition herein.

The Question of Retroactivity Arises, However, in Connection with Construction of the Regulation and Does Not Present a Separate Issue.

The ultimate question in this case is the application to the facts and findings herein of Article 105 of Regulations 74. Interpretation of the Regulation in the light of the statute's language, and the effect to be given to the Commissioner's rulings, dovetail into the general question of how Article 105 shall be construed.

The course of interpretation ascribed thereto by Respondent, taken in the light of the subsequent change in language of the Regulation, all resolves itself in the last analysis to the judicial construction that this Court may afford to Article 105 of Regulations 74 as it read under the Revenue Act of 1928 and the Revenue Acts in force for the ten years next preceding.

This Court has frequently adverted upon the judicial effect afforded to long-established administrative practice, and for its views as recently as November, 1935, we beg leave to invite attention to *McFeely* v. *Commissioner*, 296 U. S. 102, at page 108:

> "The Commissioner has heretofore administered the section upon this theory. As respects the Revenue

> Act of 1921, he so ruled in 1923, and again in a very full memorandum in 1924. It was stated in briefs and at the bar that these rulings have never been cancelled or revoked, and the statement was not challenged. The repetition of the definition without material change in the subsequent acts, including that of 1928, amounts to a confirmation of the administrative interpretation."

In passing, we may observe that the above quotation was predicated upon rulings of the Income Tax Bureau, Office Decisions, and Opinions of Treasury Counsel (see footnotes 10 and 11 at p. 108), a factor that substantially impairs the force of respondent's claim (his brief, p. 22) that *Helvering* v. *New York Trust Company, supra,* limits the force of administrative rulings to Treasury Regulations or Treasury Decisions in the application of the doctrine we have just previously quoted.

CONCLUSION.

The decision below should be reversed.

Respectfully submitted,

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